

Introduction to ASC 606 Revenue Recognition

Get up to speed on the foundational elements of ASC 606, the revenue recognition standard that reshaped how companies report revenue. This course covers the standard's background, scope, and key definitions, then walks through the core principle that drives the entire framework. Whether you're new to ASC 606 or looking to solidify your understanding, this is the right starting point. You'll also explore the five-step revenue model that serves as the backbone of the standard.

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify an example of premature recognition of revenue.
- Identify one of the five steps to apply the new revenue standard.
- Recall a condition that must be met to identify a separate performance obligation.
- Identify methods authorized to estimate variable consideration in a contract.
- Recognize information that can be used to allocate the transaction price to performance obligations.

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Section 1

IMPLEMENTING THE NEW REVENUE STANDARD

Chapter Objective

After completing this assignment, you should be able to:

- Identify an example of premature recognition of revenue.
- Identify one of the five steps to apply the new revenue standard.

General

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606).

ASU 2014-09, along with subsequent amendments, resulted in the issuance of new Accounting Standards Codification (ASC) Topic 606. ASC 606 makes sweeping changes to the entire revenue recognition model previously found in ASC 605.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): *Deferral of the Effective Date*, to extend ASU 2014-09's effective dates by one year.

The revised original effective dates for implementing the new ASC 606 were as follows:

- Public entities apply the new standards to annual reporting periods beginning after December 15, 2017 (calendar year 2018).
- Nonpublic entities apply the new standard to annual reporting periods beginning after December 15, 2018 (calendar year 2019).

FASB delays effective date of ASU 2014-09 due to COVID-19

In June 2020, the FASB issued ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities*.

In response to the impact of COVID-19 on the ability of companies to implement certain new standards, ASU 2020-05 offers a limited deferral of the effective dates of the following:

- ASU 2014-09, Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (*Revenue*), and
- ASU 2016-02, *Leases (Topic 842) (Leases)*.

The new revised implementation date of ASU 2014-09 with respect to the new revenue standard, was as follows:

1. Public entities: No change. The implementation date remains for annual reporting periods *beginning after December 15, 2017* (calendar year 2018).
2. All other entities, including nonpublic entities, that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020: The implementation date is delayed for one year to the following dates:
 - a) Annual reporting periods *beginning after December 15, 2019 (calendar year 2020)*, and interim reporting periods within annual reporting periods beginning after December 15, 2020.

Observation

For a nonpublic entity that issued financial statements on or before June 3, 2020, the entity was required to apply the new ASU 2014-09 revenue standard changes in calendar year 2019. However, if an entity did not issue or have financial statements available to be issued by June 3, 2020, the effective date was delayed until calendar year 2020. Thus, most nonpublic entities implemented the revenue standard in calendar year 2020.

Since then, entities have encountered difficulties in applying the standard both in terms of its application and in including its voluminous disclosures.

I. OBJECTIVE

The purpose of new ASC 606 is to make the following key changes in U.S. GAAP and international standards (IFRS):

- a. Remove inconsistencies and weaknesses in revenue requirements
- b. Provide a more robust framework for addressing revenue issues
- c. Improve comparability of revenue recognition *practices* across entities, industries, jurisdictions, and capital markets
- d. Provide more useful information to users of financial statements through improved disclosure requirements, and
- e. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

II. BACKGROUND

Revenue recognition has been an important topic and a primary concern in recent cases of fraud and accounting violations noted by the SEC. Traditional accounting rules for recognizing revenue have become outdated as more complex revenue transactions have become the norm.

Based on several reliable accounts, revenue recognition issues have accounted for approximately 50% of all financial statement frauds. Some of the more important revenue violations involve:

1. Recognition of revenue made prematurely, such as:
 - “Channel stuffing” (shipping inventory in excess of orders, or giving customers incentives to purchase more goods than they need in exchange for future discounts or other benefits);
 - Reporting revenue after goods are ordered, but before they are shipped;
 - Reporting revenue when significant services have not been performed;
 - Improper use of the percentage-of-completion method; and
 - Improper year-end cutoff procedures.
2. Recognition of revenue that has not been earned, including:
 - Recognizing revenue on bill-and-hold arrangements, consignment sales, sales subject to contingencies, and those with the right to return goods, sales coupled with purchase discounts or credits, and other side agreements.
3. Reporting sales to fictitious or nonexistent customers.
4. Sales to related parties in excess of market value.
5. Recognizing transactions at fair value that relate to exchanges of similar assets₁.
6. Reporting peripheral or incidental transactions, such as nonrecurring gains.

In addition to traditional revenue manipulation strategies, there are numerous methods that a company can use to recognize revenue, subject to certain limitations, including:

- Traditional sales method
- Percentage completion method
- Completed contract method
- Installment sales method

Thus, it is clear that there have been simply too many variations in both methods and applications related to such a key financial statement item such as revenue.

For close to a decade, revenue recognition has been at the top of the list of the FASB’s key issues based on the annual survey of the Financial Accounting Standards Advisory Council (FASAC).

Revenue is usually the largest single item in the financial statements. According to the FASB, studies confirm that revenue is the single largest category of financial statement restatements. As a result, issues related to revenue recognition are important to tackle.

Prior to ASC 606, there has been no general standard for revenue recognition although there were more than 200 separate pieces of authoritative literature scattered throughout U.S. GAAP. Most of the detailed authority on revenue was offered within industry-specific guidance, rather than a broader-based guidance. Further, authority was scattered among previously issued APB Opinions, FASB *Statements*, AICPA Auditing and Accounting Guides, AICPA Statements of Position (SOP), FASB Interpretations and Emerging Issues Task Force (EITF) Issues, SEC Staff Accounting Bulletins (SABs), and other pronouncements. The result has been a gap (no pun) between broad conceptual guidance in the FASB concept statements, and the more detailed guidance.

Previously, the SEC issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*. SAB No. 101 concluded that revenue *should not* be recognized until it was realized.

SAB 101's model stated that realization occurred when four criteria were met:

1. Persuasive evidence of an arrangement existed
2. Delivery had occurred
3. The seller's price to the buyer was *fixed* and determinable, and
4. Collectibility was reasonably assured.

The four criteria mirrored the criteria for revenue recognition of software revenue noted in ASC 985, *Software Revenue Recognition*.

The FASB Emerging Issues Task Force (EITF) has also issued guidance on revenue recognition, particularly guidance related to e-commerce and revenue arrangements with multiple deliverables. However, because there is no general standard for revenue recognition, the EITF has been in a position to interpret, rather than establish, overall GAAP for revenue.

There have been revenue recognition issues with international standards, as well. To date, international standards have offered limited guidance on revenue-related issues, particular related to the accounting for multiple-element arrangements.

Why create the revenue project?

The FASB cites several reasons for its revenue project, including:

- a. Much of the existing U.S. GAAP for revenue was developed before the Conceptual Framework.
- b. U.S. GAAP contains no comprehensive standard for revenue recognition that is generally applicable.

- c. U.S. GAAP for revenue recognition consists of more than 200 pronouncements by various standard setting bodies that is hard to retrieve and sometimes inconsistent.
- d. Despite the large number of revenue recognition pronouncements, there is little guidance for service activities, which is the fastest growing part of the U.S. economy.
- e. Revenue recognition is a primary source of restatements due to applicable errors and fraud that undermine investor confidence in financial reporting.
- f. Users face noncomparability among entities and industries, with little information to assist in identifying and adjusting for the differences.
- g. Accounting policy disclosures are too general to be informative.
- h. Revenue data are highly aggregated, and users say they would like more detail about specific revenue-generating activities.

In May 2014, the FASB and IASB issued ASU 2014-09, *Revenue From Contracts With Customers*.

ASU 2014-09 creates new ASC 606, a single, principles-based revenue recognition standard for International Financial Reporting Standards (IFRSs) and U.S. GAAP that applies across various industries and capital markets.

The ASU does the following:

- Creates a new ASC Topic 606, Revenue from Contracts with Customers, and the IASB is issuing IFRS 15, Revenue from Contracts with Customers.
- Supersedes the revenue recognition requirements in ASC Topic 605, Revenue Recognition, and most industry-specific guidance.
- Supersedes some cost guidance included in Subtopic 605-35, Revenue Recognition—*Construction-Type and Production-Type Contracts*.
- Amends the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer (for example, assets within the scope of Topic 360, *Property, Plant, and Equipment*, and intangible assets within the scope of Topic 350, *Intangibles—Goodwill and Other*).

New ASC 606 makes the following changes to existing GAAP for revenue recognition:

- Removes inconsistencies in existing requirements
- Creates a new criterion for revenue recognition which is based on a transfer of control
- Requires that contracts be identified and segmented into performance obligations
- Requires a determination of transaction price, taking into account certain factors such as credit risk and time value, among other factors
- Makes changes to how contract costs are accounted for including requiring certain contract costs to be capitalized as assets